

Japan, Libya, and The Correction

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2011 Outlook

GDP GROWTH:
3.2%

UNEMPLOYMENT:
9.0%

INFLATION:
1.75%

FED FUNDS RATE:
0.35%

As you know, we have continued to discuss technical overextension risk and stock prices. In January, we highlighted our thoughts that the market may be entering a phase where downside risks are present, and investors should note that adding to equity exposure may not be opportune in the short term. At the beginning of this month, we restated our view that the market was in need of a resting phase. In the last couple months, we have not highlighted a *fundamental* reason why the stock market may be entering a phase of price risk.

The U.S. stock market peaked in price on February 18 at 1,344 on the S&P 500 and 12,391 on the DJIA. Since then, the market has corrected to the low (intra-day) on March 16 of 1249 on the S&P 500 and 11,555 on the DJIA. This correction represents a 7.1 percent decline from peak-to-trough. We have been expecting an *intermediate* correction of five-to-20 percent. To determine next steps, we need to look at the fundamentals as to why the correction has occurred, and understand the economic and political ramifications as to what is happening in Japan, Libya and other areas of Middle East and North Africa (MENA).

Japan – Seeking Opportunities

Attempting to find opportunities within Japan may be repugnant to some. However, as investors, taking advantage of changing environments is an appropriate role. Japan, Inc. peaked in price and performance in 1989. The Nikkei 225 Index was trading at 38,915 in December of 1989. At that time, the press was talking about the “Japanese miracle.” Many thought Japan, from an economic standpoint, was going to take over as the number one country in worldwide Gross Domestic Product (GDP). Of course, that did not happen.

Since 1989, as of the close last Friday, March 18, Nikkei 225 has lost 76 percent of its value since those earlier hay-days. According to *Barron's*, many stocks in Japan are now trading at 13-to-15x earnings (lower than the U.S.) and are selling at below book value (as compared to 2x book for the average U.S. company). Additionally, many Japanese companies are world-class in nature. From a valuation perspective, a number of Japanese companies are starting to look attractive.

What about the domestic economy in Japan? Is the earthquake and resulting problems going to wreck havoc on their economy? Over the short-term, we fully expect the Japanese economy to show some degree of contraction. However, next year we would not be surprised to see GDP growth in Japan in the five-to-eight percent growth range. This is compared to an average annual growth rate in Japan of less than one percent on average for the last six years. This growth rate surge should add to corporate profitability. Worldwide, Japan represents roughly nine percent of GDP. If the earthquake and attendant calamities lower GDP to recession-like levels, this will impact worldwide GDP by roughly 0.2 percent from previous expectations.

The bottom line is historically we have been underweight in Japan. We maintain that position, but are actively seeking additional opportunities.

Libya and MENA

From an economic standpoint, Libya means oil. From a MENA standpoint, Libya is another chapter on turning the page on *strongman* diplomacy. Egypt was the most recent to fall, and Libya may follow. The world's economic system will probably not shudder dramatically, until and unless a meaningful country falls economically. Now that the *no fly zone* is in effect, it appears the western powers are taking steps to enable the rebels to succeed in their desire for victory.

From a supply and demand standpoint, estimates show there are roughly four million barrels of oil per day that can be produced. This is beyond what the world needs to meet oil demands. If this is the case, Libya can stop producing oil with limited supply and demand impact on pricing. However, from a political uncertainty standpoint, while Libya and other such countries are going through upheavals, oil prices will remain volatile with an upside bias.

The Correction – Is the Market Safe?

We believe the U.S. stock market has been vulnerable to a short-term, intermediate correction in price. We did not know what was going to start this correction, but we now know two things: 1) Japan's economy is slowing down due to the earthquake; and 2) continued uncertainty exists regarding oil prices due to the political instability within the MENA area. Now that these fundamentals are known, we are able to assess the potential economic impact which may unfold going forward due specifically to these two surprises. Both events have provided cloudiness to many economic outlooks – ours included. Consequently, the markets corrected. Now that some time has passed and the outcomes to these issues are becoming clearer, the markets are rallying.

Longer-term primary bear markets are normally accompanied by contractions in money supply (the opposite is now occurring), the potential onset of an economic recession (the yield curve and the bond market participants are not anticipating this event), and rapidly rising interest rates (this has not happened). Consequently, we are of the opinion that we are, in some ways, off from the onset of a secular, 20-plus percent decline in stock prices.

What do we expect going forward? We stand by our outlook for U.S. equity markets this year – a potential high of roughly 1,400 on the S&P 500 and a possible low in the 1,125 range. With the market currently trading at 1,300, arithmetically we see the potential for more downside risk than upside potential. Instead of making a *strong* market call, we would prefer at this stage to focus on geographic and thematic calls.

Final Word

Now that the market has corrected by more than seven percent from peak to trough, is it safe to put money to work in U.S. equities? Perhaps, but we urge global thought. With all of the worldwide uncertainties, from political to economic, are the world's financial markets going to be volatile going forward? We believe price volatility is going to be high. We urge investors to think globally while making investment decisions. Some of the best opportunities lie outside the U.S. shores.



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